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SUBJECT: GEORGIA'S ECONOMY HOLDS ITS BREATH AS 2008 BEGINS

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¶1. (SBU) Summary: Georgia's GDP grew an estimated 12 percent in 2007, while inflation was reported at 11 percent for the year. Growth was based on increasing inflows of foreign investment and robust government spending. Because political turmoil has caused foreign investors to hesitate, although perhaps not abandon, their investment plans, growth will slow in 2008. Exports grew in 2007 despite Russian trade sanctions, and Turkey is becoming Georgia's leading trading partner. Nevertheless, the current account deficit is large and growing, and continued interest from foreign investors will be needed to maintain an acceptable balance of payments. The banking sector continued to grow strongly in 2007. Although there are no obvious signs of trouble, the health of the banking sector will bear watching. Unemployment was slightly higher in 2007 than in 2006. Wages also increased, however. The government has ambitious plans to further liberalize the economy, which clocked in at number 18 on the World Bank's ease of doing business index in 2007, in order to cut unemployment and continue increasing incomes. End Summary.

¶2. (SBU) 2007 opened as a banner year for the Georgian economy, with real GDP growth accelerating from 11.4 percent in the first quarter to more than 13 percent in each of the second and third quarters of the year. It is estimated that growth will end up at 12 percent for the year. Growth was based on robust government spending and inflows of foreign investment, while growth in consumer demand was relatively flat. 2008 is shaping up to be a year of more modest growth, principally because the political uncertainty surrounding the rise and fall of Irakli Okruashvili, the November protests and the hotly disputed presidential elections in January has inevitably made some investors delay their investments or perhaps even reconsider them altogether. The government is planning to slow the growth of spending and along with it the boost it has been providing to the economy. Tourism is already noticeably slower in the ski resorts of Gudauri and Bakuriani, and continued bad publicity about Georgia would not help that important sector. The Georgian government's 2008 budget, passed in late December by the parliament, forecasts only 5.5 percent growth during 2008. The Ministry of Finance expects to see a per capita income of USD 2800 by the end of 2008, compared to USD 1200 in 2004.

¶3. (SBU) A slowdown in the flow of investment will come as a disappointment, since the government had been predicting a total inflow for 2007 of USD 2 billion, compared to the USD 307 million the country received in 2003, the last year of former President Shevardnadze's rule. Some expect the total to be about USD 1.4-1.5 billion, which nevertheless still exceeds 2006's USD 1.1 billion of investment. Georgia helped its image in 2007 by improving its showing on the World Bank's "Doing Business" report from number 34 in the world to

an impressive number 18. The investment that the country has been receiving has been concentrated in the financial and real estate sectors and has not brought readily noticeable benefits in new employment, a situation that contributed to dissatisfaction with the Saakashvili administration expressed in the November protests and the January election. On the other hand, manufacturing and mining have shown relatively strong growth, 15 percent in 2006 and perhaps a similar amount in 2007. This is attributable to strong external demand for ferroalloys, cement, and domestic demand for food products, textiles and construction materials. If these trends continue, the supply of new jobs may begin to more strongly benefit the average Georgian household and to shore up support for the government. Unfortunately, such employment may never spread far enough to benefit older workers and those who lack skills -- not an insignificant part of the population.

¶4. (SBU) The more rancorous political climate has brought a re-orientation of the government's budget priorities. Fast growth of the economy, better tax administration and reduction of corruption continue to give the government more resources with which to work. At a recent briefing to the diplomatic corps, Finance Minister Nika Gilauri told his audience that the government received GEL 5.9 billion (USD 3.68 billion) in revenues in 2007, 1 percent more than the planned receipts for the year. Government revenues were only GEL 1.2 billion in 2003. The GOG is budgeting for GEL 5.15 billion in revenues in 2008, of which only 6 percent will come from privatizations. In a recent Wall Street Journal interview, PM Gurgenidze said that the government wants to sell 25 percent of its remaining industrial assets in 2008. One of the companies to be sold is Georgian Railways, which has attracted the attention of some American investors. Gilauri said that the government is planning to turn its

attention from building and repairing infrastructure to ameliorating social problems. The areas of expenditure in the 2008 budget that are receiving the largest increases are health and education, as well as pensions, and the entire share of social programs will increase from 28 percent in 2007 to 33 percent in 2008. Defense expenditure will be sharply down. Total expenditure of GEL 5.7 billion, as planned, would result in an estimated budget deficit of about 2-3 percent of GDP, compared to 2007's estimated 5 percent.

¶5. (SBU) Inflationary pressures increased during 2007. Year-end inflation was 11 percent, and the government was unable to keep the figure in single digits as it had wished. Some economic experts, such as the Georgian Foundation for Strategic and International Studies' Lado Papava, claim that inflation is really much higher. Poorer Georgians certainly have been hit hard by higher food prices, and their concerns are undoubtedly contributing to Saakashvili's unpopularity. If investment and growth slow down as expected, inflationary pressure may be somewhat less in 2008. On the other hand, although the government has expressed a desire to rein in spending, the fact is that 2008 is an election year and the impulse to spend, especially on measures that put money in the consumer's pocket, will be difficult to resist. If it is unwilling to slow expenditures, the government has only some very rudimentary tools to use on the monetary side to control inflation. It has expressed a willingness to allow the lari to appreciate, bearing some of the brunt of the fight. The National Bank of Georgia (NBG), the central bank, has conducted regular auctions of certificates of deposit since late 2006, but has not met its targets because it has been unwilling to offer interest rates that will clear the market. The government has yet to make the government securities held by the NBG fully marketable and has been reluctant to issue new domestic debt that could be used for open market operations.

¶6. (SBU) Reflecting government concern about inflation, if not a truly effective response to the problem, the government

in late 2007 announced that it intends to introduce legislation that will require the president of the central bank to resign if inflation exceeds 12 percent per year, and to appear before the Parliament if it tops 7 percent. For its part, the government is considering legislation to require budget surpluses. A tighter fiscal policy conforms with IMF recommendations, even though the IMF's last program expired in mid-2007. The central bank proposal is in line with continuing hostility to the NBG and its independence from some government figures, notably Prime Minister Gurgenidze and ex-Minister for Reform Kakha Bendukidze, who will remain in the government as an advisor to the Prime Minister and head of the Chancellery. Bendukidze is promoting a currency board for Georgia to strip the NBG of its monetary policy setting function, but has not achieved much traction for the idea. He has had more success with a proposal to fold the NBG's banking regulation function into a Financial Supervision Agency, that would have oversight of the stock exchange, insurance and money laundering as well. No NBG president has been nominated to replace Roman Gotsiridze since he resigned last year. The acting director, David Amaglobeli has actually grown in respect since he took the helm of the bank after Gotsiridze. The pressure on the central bank is likely to continue and even increase in the next few months.

¶7. (SBU) Russian trade sanctions on Georgia continued through early 2008. There are some signs that the Government of Russia is ready to discuss lifting the bans on wine and mineral water exports from Georgia, but only time will tell whether the statements are sincere, and whether Georgian officials are ready to respond in kind. Despite the trade problems with Russia, Georgia's exports continued to grow through 2007. In 2007, Georgia exported USD 1240.2 million in goods, 25 percent more than it did in 2006. The CIS countries as a group were Georgia's biggest export market. Of them, Azerbaijan stands out as a destination for Georgian exports. The EU, as a whole, absorbed 21.7 percent of Georgia's exports. Among individual countries, Turkey was Georgia's single biggest export partner (USD 171.7 million) followed by the U.S. which received USD 149.5 million of Georgian exports, according to Georgian statistics. Russia, formerly Georgia's single largest export partner, took only USD 53 million in exports, compared to USD 154 million in 2005, before the embargoes were imposed.

¶8. (SBU) Wine is the best known Georgian product, and the Russian embargo has taken a serious toll on exports. Total wine exports from Georgia to the world declined from USD 81.3 million in 2005, before the embargo, to USD 29.2 million in
¶2007. Ukraine is now by far Georgia's best market for wine,

absorbing 50 percent of Georgia's total exports of the product. Russia took 77 percent of Georgia's wine exports in 2005 but virtually none in 2007. Poland and Czech Republic doubled their modest imports of Georgian wine since 2006, but other markets in the EU, including the Baltics, remained flat or even declined, as did the United States. Overall, leading Georgian exports in 2007 were iron and steel (including scrap), mineral ores, beverages (mineral water, wine and spirits), vehicles and fruits and nuts.

¶9. (SBU) Despite sharply increased prices for Gazprom-supplied natural gas, Russia took a back seat to Turkey on imports into Georgia in 2007. (Note: Turkey concluded a free trade agreement with Georgia late in the year that promises further increases in trade with that country.) Other important sources of imports, which totaled 5.2 billion in 2007, include Ukraine and Azerbaijan. The latter country became a major energy supplier to Georgia for the first time in 2007. The EU countries, notably Germany and Italy, together supplied 35.5 percent of Georgia's import needs. The United States supplied 3.9 percent (USD 203.9 million). Overall, the figures indicate that Georgia has rapidly re-oriented its trade away from Russia, although

relationships with other countries of the former Soviet Union remain strong.

¶10. (SBU) Even though exports are stronger, Georgia is still faced with financing a significant 20.2 percent of GDP current account deficit, which has grown from 15.3 percent in ¶2006. Remittances from Russia, the U.S. and other countries (which totaled 7 percent of 2007 GDP), foreign assistance and stronger inflows of foreign investment have permitted Georgia to cover the gap and maintain a positive balance of payments. As a result of these inflows and NBG intervention to dampen the appreciation of the lari, international reserves at the central bank were USD 1.3 billion at the end of 2007, compared to USD 930 million at the end of 2006. This relates to approximately three months of import cover. The economy's strong demand for imports is unlikely to abate, and points up one of the key vulnerabilities of the economy, that is, if investment slows and less state assets are available for privatization, it will become more difficult for the country to fund its appetite for imported goods -- many of which are consumer items that are not available from domestic producers. The central bank's reserves peaked in October 2007 and dropped late in the year and in January 2008, as the inward flow of foreign exchange stalled, perhaps temporarily. The situation will not become critical if interest among foreign investors begins to pick up again fairly soon.

¶11. (SBU) As a result of increasing inflows of investment and remittances, global weakness of the dollar and more willingness on the part of the NBG to use the exchange rate as an anti-inflation tool, the lari appreciated considerably against the dollar in 2007. It finished the year at 1.59 lari to the dollar, appreciating 7.7 percent over the year. It gained 3.6 percent against the euro.

¶12. (SBU) In 2007, the growth of the financial sector continued. Commercial banking assets increased by 70 percent, and profits by 65 percent. Despite worries about a global credit crunch, Georgian banks continue to attract capital, including a USD 65 million credit facility from Merrill Lynch to Bank of Georgia announced on January 10. According to the NBG, overdue loans in October 2007 were 1.5 percent of the total, compared to 2.3 percent a year earlier. However, given rapid growth and the history of financial problems experienced by other economies undergoing similar transitions, the health of the banking sector bears watching. The Galt and Taggart Index, which measures the small stock market in Georgia, increased from 790 to 1041 over the year, although it peaked around 1500 in August before news of the Okruashvili affair broke.

13.(SBU) Available unemployment and wage statistics are not especially current, but as of the second quarter of 2007, the unemployment rate was 14.9 percent (ILO strict methodology), 2 percentage points higher than in the same period of 2006. This figure considerably understates the unemployment picture, and there has been little change in the poverty picture, with one in four Georgians living at or below the official poverty line. At the same time, average private sector wages were on an upward vector, reaching GEL 385 (USD 240) per month in the third quarter of 2007, according to the Department of Statistics.

¶14. (SBU) Georgia's new Prime Minister, Lado Gurgenidze, was president of the largest commercial bank in Georgia, the Bank of Georgia. As a financial expert, he is taking a great interest in Georgia's economic future. In December, he

announced a low-interest loan program for entrepreneurs that he said will begin in February or March of 2008. In late January, after the presidential elections, Gurgenidze submitted a package of economic measures to the Parliament, mostly aimed at further liberalizing the financial system, the tax code, and customs regulations. The package includes a proposal to reduce the new 25 percent income tax to 15

percent over the next five years. (Note: the social tax on wages was abolished when the income tax was raised to 25 percent.) Corporate taxes are 15 percent of income, and plans include eliminating taxes on dividends and interest income in 2009. The law would require the government to maintain a budget surplus of at least 0.1 percent of GDP. The surplus would be saved in funds for "future generations" (including costs of reconstruction of Abkhazia and South Ossetia after reunification) and for unexpected economic challenges. A single regulator for the banking, insurance, securities and other financial services will be established. Stock exchange and other investor rules will be liberalized, and anti-money laundering laws will be amended to "streamline" rules for bank ownership while increasing transparency of ownership structures. Gurgenidze's express objective is to make Georgia an international financial center in the mold of Cyprus, attracting billions of dollars of portfolio investment. Gurgenidze and the government are also banking on the development of a free economic zone in Poti, where business will be free of almost all taxes, to boost employment and growth.

¶15. (SBU) Comment: The government's political difficulties with the opposition have not dented its resolve to make Georgia the most liberal economy between Ireland and Singapore. But whether Georgia can peacefully resolve its political difficulties -- not only with the opposition, but also with Russia and the breakaway territories of Abkhazia and South Ossetia -- will determine how soon Georgia can reach the peaks of economic success envisaged by the government and its new Prime Minister.
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